

REPLY

DOUBLE LIABILITY OF BANK SHAREHOLDERS: A LOOK AT THE NEW DATA

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INTRODUCTION

In a recent article, we presented a historical analysis of the regime of double liability for bank shareholders that existed in the United States between the Civil War and the Great Depression.¹ Under this regime of double liability, if a bank failed, a receiver would be appointed to determine the extent to which the bank's liabilities exceeded its assets.² Shareholders would then be required to pay an amount up to and including the par value of their stock to satisfy the outstanding claims.³ Under current law, the regime of limited liability that existed for about seventy-five years has now been replaced by a more traditional corporate law paradigm in which shareholders' risks are capped at the amount of their initial capital investment. Moreover, the protections for depositors once provided by the regime of double liability have now been replaced by a federally sponsored program of deposit insurance.

In our article, we identified one principal advantage of the regime of double liability over the current situation. We noted that, while deposit insurance has proven effective at preventing bank runs and instilling public confidence in the banking system, it also provides incentives for excessive risk taking by banks, which in turn leads to a greater risk of bank failures generally.⁴ The incentives for shareholders to engage in activities

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1. Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992) [hereinafter Macey & Miller, *Double Liability*].

2. *Id.* at 31.

3. *Id.*

4. *Id.* at 33. For further discussion regarding the causes of bank failures, see Jonathan

that fixed claimants (such as bondholders or uninsured depositors) regard as excessive risk taking is not unique to banking. As residual claimants, shareholders capture the excess returns from excessive risk taking in all contexts.⁵ Riskier ventures enrich shareholders at the expense of creditors because shareholders do not have to share any of the gains with creditors, despite the fact that creditors bear part of the risks associated with the riskier ventures.⁶

Normally, creditors, anticipating the prospect of excessive risk taking by shareholders and shareholder-controlled management, will try to control such risk taking by obtaining contractual protections, as well as by adjusting the price they are willing to pay for corporate debt obligations. However, government-provided, fixed-premium deposit insurance makes banks fundamentally different from other sorts of corporate enterprises because insured depositors are indifferent to the issue of risk. Depositors and other fixed claimants who enjoy insurance protections have no incentive even to attempt to influence or control the excessive risk-taking proclivities of the banks in which they place their funds because their funds will be protected regardless of the outcomes of the investment strategies that banks elect.⁷

The basic point of our previous *Wake Forest Law Review* article was that the double liability regime was an effective regulatory system because it mitigated the excessive risk-taking proclivities of banks.⁸ It accomplished this result by aligning the interests of shareholders with those of fixed claimants such as depositors.⁹ If a system of double liability could be made effective, shareholders and shareholder-controlled management teams would have fewer incentives to engage in excessive risk taking because they would be exposed to at least part of the costs associated with those activities. Shareholders subject to double liability are particularly appropriate monitors of bank management because—unlike subordinated debtholders or other creditor monitors—they have every incentive to encourage bank managers to increase profits while at the same time discouraging excessive risk taking because of the fear of assessment in the event of bank failure.

As we observed in our previous article, empirical evidence substantiates the conclusion that double liability was a substantial motivating factor for shareholders. We found that about 50.8 % of amounts assessed against shareholders ultimately was collected.¹⁰ This empirical finding is particularly important from a policy perspective because critics of share-

R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988) [hereinafter Macey & Miller, *Bank Failures*].

5. Macey & Miller, *Bank Failures*, *supra* note 4, at 1202.

6. See, e.g., Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653 (1984) (discussing the risk-preferring nature of shareholders as opposed to the risk-adverse nature of managers and creditors).

7. Macey & Miller, *Bank Failures*, *supra* note 4, at 1165.

8. Macey & Miller, *Double Liability*, *supra* note 1, at 61-62.

9. *Id.*

10. *Id.* at 56, tbl. 1.

holder liability have charged that it would not be possible for courts to devise workable rules to permit the administration of a regime of double liability. In fact, our historical and empirical analysis revealed that in all of the major problem areas—determining the assessment amount, identifying the persons liable for assessment, defining the scope of administrative discretion, enforcing assessments in group litigation settings, and accommodating the assessment remedy to situations where mergers and other fundamental corporate changes have occurred—courts were able to resolve satisfactorily the administrative problems involved in making double liability a meaningful regulatory system.¹¹

Another significant finding of our study was that, unlike deposit insurance, the legal regime of double liability induced caution on the part of bank managers in the use of depositors' funds.¹² The support for this conclusion lies in the fact that many more banks liquidated voluntarily during the period of double liability than went into involuntary insolvency.¹³ These voluntary liquidations meant that bank assets were conveyed into the hands of new investors without the need for costly insolvency proceedings. As we observed, "[i]f financially troubled banks can be closed early—before liabilities exceed assets—creditors, including depositors, will be paid in full."¹⁴

Double liability gave bank shareholders an incentive to liquidate their banks voluntarily before losses became too great in order to avoid insolvency. By contrast, under the current system of government-sponsored deposit insurance, shareholders have an incentive to keep their banks open as long as possible, taking ever-increasing risks in the hope that one last "roll of the dice" at some venture or other will return their banks to profitability. After all, such shareholders reason, the costs of these risks will be shouldered by the government, since the shareholders' equity claims already have been dissipated, while the benefits will flow to the shareholders.

Finally, in our previous piece, we studied failures of national banks during the 1856-1934 period to determine losses to depositors during that time frame.¹⁵ We found that during most of this period, losses to depositors were surprisingly small.¹⁶ Many banks failed, but depositors received substantial payments in liquidation.¹⁷

As part of this broader project, we studied bank failures during the 1930-34 period to determine the losses to depositors of national banks.¹⁸ In particular, we examined 688 receiverships that were terminated by October 31, 1937. We found that losses to depositors were very small.¹⁹ Spe-

11. *Id.* at 61.

12. *Id.* at 58.

13. *Id.* at 57-58.

14. *Id.* at 34.

15. *Id.* at 55-61.

16. *Id.* at 58.

17. *Id.* at 57-58.

18. *Id.* at 55-61.

19. *Id.* at 58-59.

cifically, we found that during the 1930-34 period, the average annual loss to depositors of failed national banks was only 7.7 basis points, or 7.7 cents per hundred dollars of deposits.²⁰

I. PROFESSOR JACKSON'S DATA

In a new and more complete study of national bank receiverships during the 1930-34 period, Professor Howell Jackson examines data for 1,595 national banks.²¹ Professor Jackson includes additional observations in his data set and extended the period of his inquiry concerning receiverships. While we stopped with receiverships that were completed by October 31, 1937, Professor Jackson uses receiverships that were completed as late as October 31, 1941.²² Thus, while Jackson's analysis covers the same 1930-34 period that we covered, his study includes receiverships that took far longer to complete than the receiverships we examined in our study.

In his study, Professor Jackson finds that depositor losses during the 1930-34 period were significantly higher than we reported.²³ By including receiverships that terminated between October 31, 1937, and October 31, 1941, Professor Jackson finds that depositors in the national banking system lost slightly more than twenty cents for every hundred dollars of deposits, instead of the 7.7 cents we reported.²⁴ By including receiverships that terminated even after 1941, Professor Jackson's estimates of depositor losses rise still further, to 47.9 cents per hundred dollars of depositors.²⁵

II. IMPLICATIONS

Upon the publication of our previous article, we were pleased that our early analysis had a significant impact on those participating in the ongoing debates concerning banking policy and corporate governance issues.²⁶ For example, prior to the publication of our article, Henry Hansmann and Reinier Kraakman had argued that shareholders should face unlimited liability for corporate torts.²⁷ Our analysis has helped to

20. *Id.* at 59, tbl. 2.

21. Howell E. Jackson, *Losses From National Bank Failures During the Great Depression: A Response to Professors Macey and Miller*, 28 WAKE FOREST L. REV. 919, 926 (1993).

22. *Id.* at 26-27.

23. *Id.* at 927.

24. *Id.*

25. *Id.* at 929.

26. For several articles citing Macey & Miller, *Double Liability*, *supra* note 1, in their discussions of banking policy and corporate governance, see Larry E. Ribstein, *Efficiency, Regulation and Competition: A Comment on Easterbrook & Fischel's Economic Structure of Corporate Law*, 87 NW. L. REV. 2541 (1992); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992); Peter P. Swire, *Bank Insolvency Law Now that it Matters Again*, 42 DUKE L.J. 469 (1992).

27. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

inform the debate as to whether this system could be administered.²⁸ In light of Professor Jackson's new data, it seems appropriate to reexamine the policy implications we drew from our previous analysis.

Professor Jackson concludes that "the pre-New Deal era of banking regulation was not a regulatory paradise from which we foolishly strayed in the first hundred days of Franklin Roosevelt's Presidency."²⁹ Of course, we never suggested that the double liability system was a regulatory paradise. Indeed, in our article we stressed that we did not even consider whether double liability offered any hope of addressing contemporary problems in the banking industry.³⁰

More troubling is Professor Jackson's conclusion that our data set, albeit truncated in comparison to his own, has a "critical flaw"³¹ and "seriously misstates the historical record."³² First, Professor Jackson does not challenge our data on the recovery rates on shareholder assessments.³³ Nor does he seem to doubt that the prospect of double liability induced *ex ante* monitoring.³⁴ Further, he does not dispute our findings for the more than half-century period between 1865 and 1930.³⁵ Thus, while Professor Jackson may be correct that the rule did not prevent significant losses to shareholders in the unusual conditions between 1930 and 1934,³⁶ the conclusion that *depositors would have been worse off without double liability* seems impossible to refute. Of course, the test of any economic or social policy is not whether it produces "paradise," but whether it is better than the real-world alternatives.

As noted above, Professor Jackson comments on the conclusions we reached based on our data. This is largely due to the fact that Professor Jackson has not carefully analyzed the implications of his own data. He has little quarrel with the conclusions we reached on the basis of our data. His point is that our data set, while extensive, should have been expanded.³⁷ In particular, in Professor Jackson's view, we should not have stopped with liquidations that were terminated in 1937.³⁸ He argues that by including institutions that were terminated as late as 1941 and beyond, we would have reached dramatically different conclusions about the effects of double liability on depositors' wealth.³⁹

28. For articles citing Macey & Miller, *Double Liability*, *supra* note 1, in a discussion of the administration of unlimited liability for corporate torts, see Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992); Henry Hansmann & Reinier Kraakman, *Do the Capital Markets Compel Limited Liability? A Response to Professor Grundfest*, 102 YALE L.J. 427 (1992).

29. Jackson, *supra* note 21, at 930.

30. Macey & Miller, *Double Liability*, *supra* note 1, at 62.

31. Jackson, *supra* note 21, at 925.

32. *Id.* at 921.

33. *Id.* at 930.

34. *Id.*

35. *Id.* at 931.

36. *Id.* at 930.

37. *Id.* at 926.

38. *Id.*

39. *Id.* at 927.

While Professor Jackson's new data is interesting and important, the conclusions he draws require further analysis. The first and most interesting question concerns the overall data set. It is entirely inappropriate, in considering the implications of double liability, to examine only the period between 1930 and 1934 when all economic institutions faced extraordinary conditions. To assess the double liability system accurately, it is necessary to evaluate its performance over the full period of its existence. As our earlier article demonstrated, and as Professor Jackson does not dispute, the overall performance of double liability appears to have been remarkably good.⁴⁰

Second, it is important to consider why depositor losses were so much greater in those bank insolvencies that were not terminated early. In other words, the greater depositor losses found by Professor Jackson result from receiverships that dragged on beyond 1937.⁴¹ Professor Jackson reasons that "one also might reasonably suspect that [Macey and Miller] inadvertently omitted the institutions that had the worst assets and required the longest time to liquidate."⁴²

This is certainly a possibility. However, Professor Jackson provides no reason why it is necessarily the case that firms with the worst assets required the longest time to liquidate. It would be just as easy (and as plausible) to assert that firms with the worst assets required the *least* time to liquidate. After all, at the limit, where an asset has absolutely no value, liquidation simply would require that the asset be written off, a process which takes almost no time at all. Alternatively, it could be that the creditor structure of certain banks caused delays, or that certain receivers were less competent than others, or that large banks took more time to liquidate, or that the mix of assets held by certain banks caused delays in liquidation. Thus, an equally plausible explanation is that there was no difference in asset quality among the banks.

The higher losses for the slower terminations may have resulted from the simple fact that institutions that were wound up faster experienced lower losses because of the predictable decline in assets that accompanies protracted insolvency proceedings. In addition, it seems reasonable to assume that the administrative costs of a long liquidation proceeding are higher than the liquidation costs of a short proceeding. This too could account for the higher losses for depositors in cases where the receiverships were not terminated in a timely fashion.

This explanation is consistent with the basic intuition that the earlier losses are recognized and dealt with, the lower they will be. Just as early closures can reduce creditor losses, so too can early resolution of bank failures. As Professor Lynn LoPucki recently has shown, the added costs associated with the 1986 revisions to Chapter 11 of the Bankruptcy Code are attributable to the additional time involved in completing bankruptcy

40. See Macey & Miller, *Double Liability*, *supra* note 1, at 61-62 (discussing positive impact of double liability scheme on depositors).

41. Jackson, *supra* note 21, at 927.

42. *Id.* at 926.

proceedings.⁴³ Professor LoPucki found that resources are consumed during long insolvencies as creditors and debtors struggle to protect their investments.⁴⁴ Moreover, companies perform poorly during protracted insolvencies because of cash flow problems, difficulties with suppliers and customers, and the excessive time management must spend in legal and administrative matters which diverts them from operational matters.⁴⁵ Consistent with that analysis, it appears that delay in liquidations also adds costs.

Thus, what Professor Jackson has demonstrated with his expanded data set is that extending the length of time involved in the insolvency process increased depositor losses. His data cannot be interpreted to show that double liability was ineffective in stemming depositor losses. As noted above, the higher losses found in Professor Jackson's expanded sample have more to do with the shortcomings of protracted liquidation proceedings than with the shortcomings of double liability.

More important, even if the losses to depositors were higher than previously thought during the 1930-34 period, double liability remains valuable as long as it reduced losses to depositors below what such losses would have been in the absence of double liability. In other words, the critical question is whether the bank failure problem would have been worse during the Great Depression *without* double liability. Professor Jackson's data and analysis, for all of their interest and importance, do not provide even a scintilla of evidence on this point. Indeed, his own work suggests that he is in full agreement with us that the problems of moral hazard and adverse selection can be reduced by imposing expanded liability on the banking system.⁴⁶

Professor Jackson makes much of the fact that the depositor loss figures he reports are higher than the annual premiums paid by banks for deposit insurance today.⁴⁷ However, as already noted, to look only at the 1930-34 period provides an exceptionally skewed picture of depositor losses during the double liability system. Further, Professor Jackson's calculation of deposit insurance premium costs focuses exclusively on banks' out-of-pocket costs for deposit insurance, and ignores the most significant costs, such as higher capital costs, reserve requirements, lending restrictions, restrictions on portfolio content, and other regulatory and activities restrictions thought necessary to implement the deposit insurance system. Thus, it is inappropriate to compare depositors' losses during the early 1930's with modern FDIC insurance premiums as Professor Jackson does, because his calculations ignore all of the extra costs associated with the current system, and thereby makes the modern system of federally spon-

43. Lynn M. LoPucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729.

44. *Id.* at 732-37.

45. *Id.* at 738.

46. Howell E. Jackson, *The Expanding Obligations of Bank Holding Companies*, 107 HARV. L. REV. (forthcoming 1994); Howell E. Jackson, *The Superior Performance of Savings and Loan Associations with Substantial Holding Companies*, 22 J. LEGAL STUD. 405 (1993).

47. Jackson, *supra* note 21, at 930.

sored deposit insurance appear much less costly than it actually is.

CONCLUSION

Professor Jackson's expanded data set presents an improvement on the data set compiled in our earlier article for the 1930-34 period. However, it would be inappropriate to conclude from his new and improved data that double liability for depositors was a failure.

Professor Jackson's article does not dispute the fact that during the vast preponderance of the life of the system, double liability was a success.⁴⁸ His new data addresses only the 1930-34 period when conditions throughout the economy were extraordinarily disrupted. It would be perilous to assess the value of double liability on the basis of its performance during this period alone.

Further, Professor Jackson draws unnecessarily sweeping conclusions with respect to the 1930-34 period. With Professor Jackson's recent contribution to the literature, we have what is, in effect, two discrete data sets for this period. One should not be too quick to combine the two sets in the way that Professor Jackson has done in his reply to our previous article. The first data set consists of our numbers, which include receiverships that were terminated by October 31, 1937.⁴⁹ The second data set consists of the receiverships that were terminated by October 31, 1941.⁵⁰ The losses in the second data set are much higher than the losses in the first. This difference might be attributed to a failure of the double liability system, as Professor Jackson suggests; however, it could just as plausibly be attributed to a failure of protracted receiverships. Professor Jackson may only have shown that the salutary effects of double liability can be reduced if the banks are wound up by incompetent receivers who take too long to do their job, thereby causing the assets under their control to deteriorate.

In any event, Professor Jackson supports our basic conclusion that recovery rates from stockholders were high.⁵¹ This was our main point, because as long as a system of double liability can be made to work administratively, it will reduce the adverse selection and moral hazard problems that create incentives for excessive risk taking among bank shareholders and shareholder-controlled management teams. That analysis is not in dispute.

With regard to comparing loss rates with deposit insurance premiums, historical comparisons of this kind are difficult, particularly because, as noted above, the regulatory regime is much different today and the nominal cost of deposit insurance premiums captures only a fraction of the costs associated with that regulatory system. Double liability is desirable because it mitigates the adverse selection/moral hazard problems as-

48. *Id.* at 931.

49. Macey & Miller, *Double Liability*, *supra* note 1, at 56.

50. Jackson, *supra* note 21, at 927.

51. *Id.* at 930.

sociated with deposit insurance. Thus, Jackson's data does not disturb our point that double liability might be a natural complement to a private deposit insurance regime, because double liability forces the beneficiaries of bank risk taking to internalize the costs of risk taking.

From a policy standpoint, the question is whether there would have been even more bank failures and even greater losses without double liability during the 1930-34 period. While Professor Jackson's analysis has deepened our understanding of the historical record with respect to double liability during this five-year period, he has not disturbed our inference that double liability did in fact reduce both the incidence and the severity of the bank failures of the Great Depression. Nor has his work undermined the general theoretical and empirical case for double liability stock as an appropriate monitoring device for banking firms.

